

*United States Court of Appeals
for the Second Circuit*



APPELLEE'S BRIEF

75-4123

75-4201

Signed

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

IRWIN C. GUILD and BERNICE GUILD,
Appellants-Cross-Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee-Cross-Appellant

JONATHAN LOGAN, INC.,
Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellant

ON APPEALS FROM THE DECISIONS
OF THE UNITED STATES TAX COURT

OPENING BRIEF FOR THE COMMISSIONER

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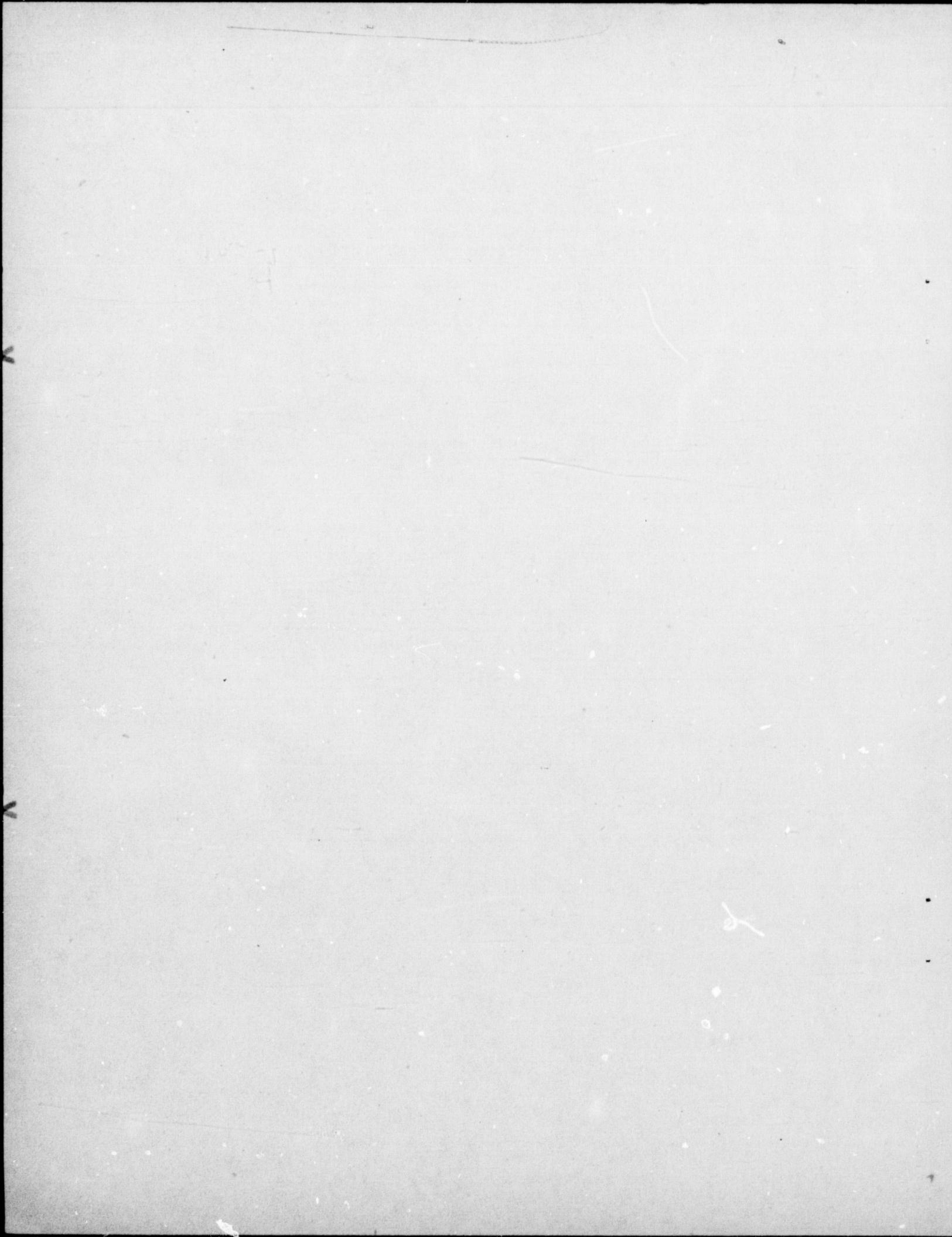
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STATEMENT OF THE ISSUES PRESENTED

Guild's Appeal in No. 75-4123:

1. Whether the Tax Court correctly decided that Guild's bargain purchase of stock of Jonathan Logan, Inc., in settlement of litigation with that corporation constituted income to him in 1967 and was not received by him pursuant to the exercise of a

restricted stock option under Sections 421 and 424 of the Internal Revenue Code of 1954.

2. Whether the Tax Court correctly decided that the income realized by Guild on his bargain purchase of stock of Jonathan Logan, Inc., constituted ordinary income and not capital gain.

3. Whether the Tax Court abused its discretion in denying Guild's attempts to raise the issue of restrictions on the stock he received when such issue was raised for the first time after the Tax Court had entered its findings of fact and opinion in this case.

Commissioner's Cross-Appeal in No. 75-4123:

If Guild should prevail on any of the issues described above, whether he is entitled to a deduction for attorney's fees paid in connection with his litigation with Jonathan Logan, Inc.

Commissioner's Appeal in No. 75-4201:

If this Court should decide that Guild received the stock pursuant to the exercise of a restricted stock option, whether Jonathan Logan, Inc., should be disallowed a deduction under Section 421 with respect to such stock.

STATEMENT OF THE CASE

These cases are consolidated appeals from the Tax Court.

Irwin C. Guild and Bernice Guild v. Commissioner, No. 75-4123 (Tax Court Docket No. 8284-72), will hereinafter be referred to as Guild. Jonathan Logan, Inc. v. Commissioner, No. 75-4201 (Tax Court Docket No. 8218-72), will hereinafter be referred to as Logan. The consolidated memorandum findings of fact and

opinion of the Tax Court (Judge Wiles) (R. 43a-54a), ^{1/} filed on September 16, 1974, are unofficially reported at 33 T.C.M. 1045 (1974). On May 1, 1975, the Tax Court entered its decision in ^{2/} Guild, determining a deficiency in Guild's income tax liability for the year 1967 in the amount of \$137,662.26. (R. 55a.) Also on May 1, 1975, the Tax Court entered its decision in Logan, determining a deficiency in the income tax liability of Jonathan Logan, Inc. (Logan), for the year 1967 in the amount of \$54,581.97.

(R. 56a.) Guild filed a timely notice of appeal on June 9, 1975.

(R. 1a.) The Commissioner filed a timely notice of appeal in Guild on June 24, 1975. (R. 2a.) The Commissioner filed a timely notice of appeal to this Court in Logan on July 23, 1975. (R. 3a.) ^{3/}

1/ "R." references are to the separately bound joint appendix.

2/ References to Guild are to Irwin C. Guild. Bernice Guild is a party to this case because she filed a joint return with her husband for the year in issue.

3/ Statutory venue in Logan lay in the Third Circuit. However, pursuant to Section 7482(b) of the Internal Revenue Code of 1954 (26 U.S.C.), the parties in Logan have stipulated to venue in this Circuit. (R. 4a.) The notice of appeal to the Third Circuit filed by the Commissioner on June 16, 1975, in Logan was dismissed on August 14, 1975. (R. 14a.)

The parties have executed and filed a stipulation to consolidate these appeals, which has been approved by this Court. (R. 5a-7a.) Jurisdiction is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

The relevant facts of this case, as found by the Tax Court, may be summarized as follows:

On September 24, 1963, Guild entered into an employment agreement with Logan. This agreement provided for Guild's employment as executive sales manager of Logan's R & K Originals Division until December 31, 1965. Guild's salary was to be \$30,000 per year plus a \$25,000 per year expense allowance. In addition, in a separate agreement, Guild was granted an option to purchase 25,000 shares of Logan common stock at \$15.46 per share. (R. 45a.) This option was exercisable for the indicated number of shares during the following periods (R. 45a):

On or after September 24, 1964	-	10,000 shares
On or after April 1, 1965	-	5,000 shares
On or after April 1, 1966	-	5,000 shares
On or after April 1, 1967	-	5,000 shares

This option was also subject to certain other conditions.

Paragraph 5 provided that, in the event of the termination of Guild's employment with Logan, Guild's right to purchase stock pursuant to the option would cease "for all purposes," unless such termination occurred during an exercise period. If the termination occurred during an exercise period, Guild could purchase stock pursuant to the option (to the extent to which the option was exercisable at the time of termination) for a period of three months from the date of termination. However, if Guild's employment were

terminated "for cause," all of his rights under the option agreement would expire immediately upon termination. (R. 46a.)^{4/}

Paragraph 6 of the option agreement set forth the manner in which the option was to be exercised. The prescribed manner of exercise was for Guild to provide written notice to Logar of his election to exercise the option, specifying the numbers of shares to be purchased, accompanied by payment in cash, certified check, or cashier's check of the purchase price for the number of shares being purchased. (R. 46a.)^{5/}

4/ Paragraph 5 of the option agreement provided as follows (R. 46a.):

5. Termination of Employment and Death:
If your employment by the Company or subsidiary terminates, this option shall cease for all purposes except that if such termination shall occur during the Exercise Period, this option may thereafter be exercised (to the extent to which it was exercisable at the time of such termination) during a period of three (3) months from the date of such termination, but not, in any event, later than the Expiration Date * * *. Notwithstanding the foregoing provisions, if your employment is terminated for cause, all of your rights hereunder shall expire immediately upon such termination.

5/ Paragraph 6 of the option agreement provided as follows (R. 46a.):

6. Manner of Exercise: Should you desire to exercise your option to purchase any of the shares which at the time you are entitled to purchase hereunder, you shall give written notice of such election to the Company at its principal office in North Bergen, N. J., specifying the number of shares to be purchased, which notice shall be accompanied by payment to the Company in cash (or certified or bank cashier's check) of the purchase price for the number of shares being purchased. At the same time, you shall represent and agree with the Company in writing that you are acquiring the shares for investment purposes. The Company shall not be obligated to deliver any shares until

Guild exercised his right to purchase the 10,000 shares subject to option during the first exercise period in October, 1964. On November 10, 1964, Logan terminated Guild's employment. The following day, Guild spoke with Logan's president and requested that he be given what he considered was due him under his employment agreement, including the asserted right to purchase an additional 15,000 shares pursuant to the option agreement. He was told that the matter would have to be litigated. (R. 47a.)

Guild filed suit against Logan on January 15, 1965, in the United States District Court for the Southern District of New York. This suit was dismissed without prejudice. A new suit was instituted in the New York state courts. (R. 47a.) In this action Guild alleged that he sustained damages as follows due to Logan's alleged breach of the employment agreement (R. 47a):

a)	Salary	\$62,639.00
b)	Cash expense allowance	3,410.00
c)	Automobile	4,100.00
d)	Credit card (personal use)	2,733.00
e)	Trips abroad	6,000.00
f)	Health insurance	251.84
g)	Deprivation of the right to purchase the remaining 15,000 shares of stock covered by the option	

57 (continued) they have been listed upon each Stock Exchange upon which outstanding shares of common stock at the time are listed, and not until there has been compliance with such laws and regulations as the Company may deem applicable. No fractional shares shall be delivered hereunder. Before issuing any shares upon exercise, the Company may require you to furnish a written representation that you are acquiring the shares for investment and not for distribution.

Guild's action against Logan was settled on November 20, 1967, when Guild paid Logan \$100,490 for 6,500 shares of Logan stock having a market value of \$54.50 per share, or \$354,250 for all the shares. This settlement was in satisfaction of the claims Guild had asserted against Logan. (R. 48a.)

Guild transferred 388 shares of the Logan stock to his attorney as payment for his services in connection with the litigation against Logan. The 388 shares had a fair market value of \$22,116 for which the attorney paid \$5,999.48. (R. 48a.)

On his 1967 federal income tax return, Guild reported no income in connection with his bargain purchase of Logan stock. (Ex. 1-A.) Upon audit, the Commissioner determined that Guild realized ordinary income on that transaction in the amount of the difference (\$253,760) between the fair market value of the stock and the amount he had paid for it (i.e., the bargain element). (R. 26a.) A deficiency in Guild's 1967 income tax liability was determined accordingly. (R. 23a.)

On its 1967 federal income tax return, Logan deducted, as an ordinary and necessary business expense (i.e., compensation), the difference between the fair market value of the stock it transferred to Guild and the amount he had paid for it. Upon audit, the Commissioner determined that Guild had purchased the Logan stock pursuant to the exercise of a restricted stock option, which, pursuant to Section 421 of the Internal Revenue Code of 1954, rendered the bargain element in that transaction nondeductible by Logan. A deficiency in Logan's federal income

tax liability for the year 1967 was determined accordingly.

(R. 30a-32a.) This determination, admittedly inconsistent with that taken with respect to Guild, was taken in order to protect the revenue.

Both Guild and Logan petitioned the Tax Court for redetermination of the respective deficiencies asserted against each of them. The Tax Court held that Guild's purchase of Logan stock was not the exercise of a restricted stock option under Section 424 of the Code. Consequently, Guild must recognize income and Logan is allowed a deduction with respect to the bargain element of that transaction. (R. 52a.) The Tax Court further held that the income so realized by Guild was ordinary income and not capital gain. (R. 54a.) The Tax Court also held, pursuant to the Commissioner's concession, that Guild is entitled to a deduction for the legal fees he paid in connection with his lawsuit against Logan since he realized ordinary taxable income from that law suit. (R. 54a.)^{6/}

^{6/} Due to its conclusion that the transaction did not constitute the exercise of a restricted stock option the Tax Court did not reach the issue whether Guild's transfer of Logan stock to his attorney constituted a disqualifying disposition under Section 424(a)(1). Should this Court reverse the Tax Court on the restricted stock option issue, a remand would be appropriate to determine the disqualifying disposition issue.

Decisions were entered accordingly. (R. 55a, 56a.) ^{7/}

Guild appeals. The Commission's cross-appeals, protectively, in Guild on the issue of the deductibility of Guild's attorney's fees should this Court decide either that he realized no income on the transaction or that he realized capital gain. Finally, the Commissioner appeals, protectively, in Logan on the deductibility by Logan of the bargain element in this transaction should this Court hold that Guild purchased the Logan stock pursuant to the exercise of a restricted stock option.

^{7/} The decision of a deficiency in Logan (R. 56a) is based upon an issue settled prior to trial.

SUMMARY OF ARGUMENT

Guild's Appeal in No. 75-4123:

1. Gross income includes the fair market value of property received as compensation for services less any amount paid for such property. This rule includes in gross income bargain purchases of a corporate employer's stock, whether such stock is purchased pursuant to the exercise of a stock option or otherwise. Furthermore, the proceeds of a lawsuit for compensation retain their character as compensation taxable as ordinary income. In this case, the stock options granted to Guild in connection with his employment agreement were clearly compensatory. His lawsuit against Logan for the alleged breach of this employment agreement, in which the loss of his rights under the option agreement was the most significant element of the damages alleged, was just as clearly a suit for compensation. Consequently, the proceeds of the settlement of that lawsuit, taking the form of a bargain sale of Logan stock to Guild, retain their character as compensation for services, and are taxable to Guild as ordinary income to the extent of the bargain element on that transaction.

2. Contrary to Guild's argument, his bargain purchase of Logan stock did not constitute the exercise of a restricted stock option under Section 424 of the Internal Revenue Code of 1954, and therefore cannot qualify for the special nonrecognition benefit of Section 421. By the terms of the option agreement itself, Guild's rights under that agreement ceased for all purposes upon the termination of his employment with Logan.

In any event, that purchase, which occurred on November 20, 1967, failed to meet Section 424(b)(2)(B)'s requirement that the option be exercised within three months of the date Guild ceased to be a Logan employee, which, here, was November 10, 1964.

Guild's arguments against this result are based upon assumptions which are not supported either by the facts or by the law. His assertion that he was discharged by Logan without cause is not supported by any facts surrounding the circumstances of his discharge. Thus, the Tax Court found that Guild failed to meet his burden of proof on this issue. The equivocal language in Logan's settlement letter, which the Tax Court did not regard as an admission of liability, is not sufficient to show that this finding is clearly erroneous.

Guild's contention that he exercised the options on November 11, 1964, is similarly without support. His oral demand for his alleged rights under the option agreement did not constitute an acceptance of Logan's offer to sell stock contained in the option agreement, which required that Guild provide written notice of his election to exercise the option and tender the purchase price in cash or certified check. Guild's oral demand did not obligate him to purchase any amount of Logan stock.

Likewise, Guild has failed to establish that he could have gotten specific performance of the option agreement in the New York courts. Moreover, even if equitable relief were available, the most that Guild could expect would be the right to purchase 5,000 shares of Logan stock on April 1, 1965,

which would again exceed the three-month requirement of Section 424(b)(2)(B). An order allowing him to purchase stock as of the date of termination would constitute a modification of the option agreement both with respect to the availability of exercisable options at the time of termination and with respect to the sales and profits requirements contained in the option agreement. Such a modification would amount to a new option under Section 425(h) and, again, could not qualify as the exercise of a restricted stock option.

Finally, Logan's settlement of the lawsuit did not constitute a retroactive acceleration of the options to the date of Guild's purported exercise of such options on November 11, 1964. To repeat, Guild's oral demand on that date was not an exercise of the options. Nor did Logan ever admit that Guild had any rights under the option agreement. Moreover, any such action by Logan would again constitute a modification of the option agreement and preclude its qualification as a restricted stock option.

In short, there is no set of circumstances which can convert Guild's bargain purchase of Logan stock into the exercise of a restricted stock option.

3. There is nothing in the law which allows Guild to treat his income on this transaction as capital gain. The exchange of compensatory stock options results in ordinary income. Section 1234 of the Code, which gives capital gain treatment to gain on the sale or exchange of an option in certain circumstances,

excludes from its coverage gain on the exchange of compensatory stock options.

4. Guild's final argument is that alleged securities restrictions on the Logan stock allows him to defer recognition of his gain on this transaction. However, Guild did not raise this argument in his pleadings, and the Tax Court properly refused to consider this argument when it was raised for the first time after the Tax Court filed its opinion in this case. In light of the fact that Guild could easily have been aware of this argument before he filed his petition in this case, and the fact that a further trial would have to be held on the issue, (since there is no evidence that such restrictions existed) it cannot be said that the Tax Court abused its discretion in denying his untimely attempts to raise a new issue.

Commissioner's Cross-Appeal in No. 75-4123:

The Commissioner cross-appeals in Guild only protectively. If this Court should sustain the Tax Court on its holdings that Guild must recognize ordinary taxable income on this transaction, then he is entitled to a deduction for attorney's fees paid in connection with his lawsuit against Logan.

If, however, this Court should conclude that Guild need not recognize income, or that such income is capital gain, the deduction for attorney's fees is not allowable. In such event, the fees in connection with the litigation would be expenses incurred in acquiring a capital asset and must be added to Guild's basis in the Logan stock, or, respectively, would be expenses incurred in connection with the disposition of a

capital asset (i.e., the stock options) and are an offset against the amount realized.

Commissioner's Appeal in No. 75-4201:

The Commissioner also appeals in Logan only protectively. If this Court should affirm the Tax Court that Guild's bargain purchase of Logan stock did not constitute the exercise of a restricted stock option under Section 424, then Logan is entitled to a deduction with respect to that transaction.

If, however, this Court should reverse the Tax Court in Guild on the Section 424 issue, then, under Section 421, Logan is not entitled to a deduction on the transaction. Under Section 421, the determination under Section 424 governs the tax consequences of both of the parties. Thus, a reversal of Guild on this issue mandates a similar reversal of Logan.

ARGUMENT

Guild's Appeal in No. 75-4123:

GUILD REALIZED ORDINARY TAXABLE INCOME
ON HIS BARGAIN PURCHASE OF LOGAN STOCK

A. Absent the special benefits of
Section 421 of the Code, Guild
realized ordinary taxable income
on his bargain purchase of Logan
stock in settlement of his compen-
sation claims against Logan

Section 61 of the Internal Revenue Code of 1954, Appendix, infra, defines gross income as "all income from whatever source derived, including * * * compensation for services." Compensation, of course, need not be in money but may take the form of other property. §1.61-2(d)(1), Treasury Regulations on Income Tax (1954 Code), Appendix, infra. In such cases, the amount of income is the fair market value of the property received less any amount paid for the property. §1.61-2(d)(2)(i), Treasury Regulations on Income Tax (1954 Code), Appendix, infra. This rule also applies to stock of an employer corporation transferred to an employee as compensation for services for less than the fair market value of the stock. §1.61-2(d)(4), Treasury Regulations on Income Tax (1954 Code), Appendix, infra. Thus, a bargain purchase of an employer corporation's stock from such corporation by an employee of such corporation results in the realization by the employee of ordinary taxable income to the extent of the bargain element on such transaction. Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S. 177 (1945).

An independent principle of taxation, pertinent to this case, is that payments which constitute a substitute for income take on the character of the income so substituted. Hort v. Commissioner, 313 U.S. 28 (1941). When such a payment is received as a result of litigation, the character of the payment is determined by the character of the underlying claim. Raytheon Production Corp. v. Commissioner, 144 F. 2d 110 (C.A. 1, 1944), cert. denied, 323 U.S. 779 (1944). Thus, in Raytheon, damages received as the result of an anti-trust action were held to be taxable as ordinary income because they constituted a substitute for the ordinary business income the corporation would have received in absence of the tort. Similarly, amounts received as a result of a lawsuit for breach of an employment contract are taxable as ordinary income. Knuckles v. Commissioner, 349 F. 2d 610 (C.A. 10, 1965). In addition, as Raytheon and Knuckles make clear, it is immaterial that the proceeds of the litigation are received as a result of a settlement as opposed to a final judgment in favor of the taxpayer.

Applying these principles to the facts of this case, it is clear that Guild realized ordinary taxable income upon his bargain purchase of Logan stock. Guild's suit against Logan was based upon an alleged breach of his employment contract. (R. 47a, 78a-82a.) His alleged damages included loss of salary and loss of favorable stock options. (R. 47a, 81a.) These items, including the stock options (Commissioner v. LoBue, supra) clearly represented his loss of compensation for personal services. Had they

been realized by Guild, they would have been taxable to him as ordinary income. This result does not change merely because Logan elected to settle the suit for less than the amount claimed by Guild nor because the settlement took the form of a bargain purchase by Guild of Logan stock. As a substitute for compensation for his personal services, the bargain element of this transaction is taxable to Guild as ordinary income.

To be sure, Section 421 of the Code, Appendix, infra, provides a different rule in the case of an employee purchasing an employer's stock pursuant to his exercise of certain statutory stock options described in Sections 422, 423, and 424 of the Code. In such instances, Regulations Sections 1.61-2(d)(1) and 1.61-2(d)(4) expressly defer to Code Section 421. Guild argues that he falls within one of these exceptions. The Government disputes this and will address itself to Guild's argument on this point later in this brief. The point here is that, in the absence of the special benefits of Section 421, the rules described above apply to Guild's bargain purchase of Logan stock in this case. See Commissioner v. LoBue, supra, p. 248, n. 6. See also, H. Rep. No. 2319, 81st Cong., 2d Sess., p. 97 (1950-2 Cum. Bull. 350). The result of such application here is that Guild has realized ordinary taxable income.

We turn, then, to a discussion of Guild's efforts to avoid this result.

B. Guild's bargain purchase of Logan stock did not constitute the exercise of a restricted stock option within the meaning of Section 424 of the Code

Section 421(a) of the Internal Revenue Code of 1954, Appendix, infra, provides generally that an individual realizes no income upon the exercise of certain statutory stock options described in Section 422 (dealing with "qualified stock options"), Section 423 (dealing with "employee stock purchase plans"), or ^{8/} Section 424 (dealing with "restricted stock options"). Only restricted stock options under Section 424, Appendix, infra, are pertinent to this case. Under Section 424(b), a restricted stock option is defined as "an option granted after February 26, 1945, and before January 1, 1964 * * *, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations," if, generally, (1) at the time the option is granted the option price is at least 85 percent of the fair market value of the stock subject to option, (2) the option by its terms is not transferable and is exercisable, during the lifetime of the employee, only by him, (3) such employee does not own more than 10 percent of the stock of the issuing corporation, and (4) the option by its terms is not exercisable more

^{8/} Conversely, in any such event, the corporation transferring the stock is denied a deduction with respect to such transfer under Section 421(a)(2). This aspect of Section 421 will be discussed in greater detail in the Commissioner's argument as protective appellant in Logan, infra.

than 10 years from the date it is granted. If these requirements are met, Section 424(a)(2) provides that the nonrecognition benefit of Section 421(a) will apply if, at the time of the exercise of the option, the taxpayer is either an employee of the issuing corporation or had ceased to be an employee of such corporation within the previous three months.^{9/} Finally, under Section 425(h)(1), Appendix, infra, any modification, extension, or renewal of an option is treated as the granting of a new option. Section 425(h)(3) defines the term "modification" as "any change in the terms of the option which gives the employee additional benefits under the option," but does not include an acceleration of the exercise time.

^{9/} Section 424(a)(1) also provides that the individual must not dispose of such stock within two years from the date the option is granted nor within six months from the date such stock was transferred to him. If these requirements are not met, Section 421(b) provides that income is realized in the year of such disposition. If the holding period requirements are met, then any appreciation on such stock will generally be considered capital gain upon disposition unless, as here (R. 67a), the option price was between 85 percent and 95 percent of the fair market value of the stock at the time the option was granted. In that event, Section 424(c)(1) provides that, upon disposition, the bargain element at the time the option was granted will be treated as ordinary income and only subsequent appreciation will be capital gain. We might also point out that, effective with the Tax Reform Act of 1969, P.L. 91-172, 82 Stat. 487, the bargain element on these transactions is subject to the minimum tax on items of tax preference under Section 56. See Sec. 57(a)(6), Internal Revenue Code of 1954 (26 U.S.C.).

There is no question in this case that the options granted to Guild by Logan at the time of his employment contract on September 24, 1963 (R. 64a-66a), constituted restricted stock options within the meaning of Section 424(b).^{10/} The question presented here is whether Guild's bargain purchase of Logan stock in 1967 in settlement of his lawsuit against Logan constituted a qualifying exercise of such stock options. The Tax Court answered this question in the negative for the simple reason that, upon the termination of Guild's employment with Logan, there were no options to exercise under the terms of the agreement itself. (R. 49a-50a.) The option agreement provided that all of Guild's rights under the agreement would cease "for all purposes" upon the termination of his employment unless such termination occurred during an exercise period. (R. 46a.) At the time of Guild's termination on November 10, 1964, he had already exercised all of the options available on that date (R. 47a) and no new options would have become exercisable until April 1, 1965 (R. 49a). Moreover, Guild's actual purchase of the Logan stock on November 20, 1967 (R. 48a), more than

^{10/} At the time the options involved in this case were issued, they were governed by Section 421 as it read prior to its amendment by Section 221(a) of the Revenue Act of 1964, P.L. 88-272, 78 Stat. 19. Old Section 421 generally comprised the rules now contained in Sections 421, 424, and 425. The 1964 amendments restructured the statute into its present form, limited restricted stock options to those granted prior to January 1, 1964, and added the provisions concerning qualified stock options (Section 422) and employee stock purchase plans (Section 423). These new provisions are generally more restrictive than the old restricted stock options. This may explain why Guild's stock option agreement, by its terms, extended some two years beyond his employment contract. (R. 45a.) We might also mention that, effective with the Tax Reform Act of 1969, supra, Section 83 of the Internal

(continued)

three years after his employment was terminated, fails to meet the three-month requirement of Section 424(a)(2)(B).

Guild argues (Br. 14-25), however, that Logan terminated his employment without cause and thereby breached the agreement, that all of the options thereby became immediately exercisable, that he "seasonably" exercised the options on November 11, 1964, when he orally demanded his rights thereunder from Logan's president, that New York law would specifically enforce his rights under the option agreement, and that Logan admitted as much in its settlement letter.^{11/} In the alternative, Guild argues (Br. 25-30) that, whether or not he was discharged for cause,

~~10/ (continued)~~ Revenue Code of 1954 (26 U.S.C.) provides additional rules with respect to restricted property, including employee stock options.

~~11/~~ In its letter of November 20, 1967, Logan stated to Guild (R. 92a):

You will recall that on or about September 24, 1963, we granted to you an option to purchase 25,000 shares of our common stock. You exercised the option with respect to 10,000 shares, for which you paid the option purchase price of \$15.46 per share and received the stock. You attempted further to exercise the option with respect to the remaining 15,000 shares, but your right to do so was questioned by us.

We do hereby recognize your right to 6,500 shares of our stock upon the terms and conditions of the option. You are delivering to us simultaneously with the execution hereof, the sum of \$100,490, in full payment of said shares.

Logan's sale of stock to him on November 20, 1967, was a retroactive acceleration of the option to November 11, 1964. Both of these arguments are unmeritorious and should be rejected.

First, there is nothing in the record to support Guild's assertion that he was fired without cause. He has produced no evidence whatsoever to substantiate his claim. Logan's "recognition" of Guild's "right" (R. 92a) to purchase 6,500 shares of Logan stock in November, 1967, hardly establishes that he was fired without cause in November, 1964, especially since Guild could never have had the right to purchase more than 5,000 shares under the most favorable set of facts.^{12/} The Tax Court found that Guild had failed to meet his burden of proof on this issue. (R. 52a.) In light of Guild's failure to produce any evidence as to the facts and circumstances surrounding his discharge, that finding cannot be said to be clearly erroneous.

Second, Guild did not "exercise" the options on November 11, 1964, when he orally demanded his option rights from Logan's president. The Regulations require that the exercise of an option be an acceptance of the offer to sell stock contained in an option agreement. §1.421-1(e), Treasury Regulations on Income Tax (1954 Code), Appendix, infra. The option agreement in this case specified the mode of acceptance, including written

^{12/} Guild's employment agreement expired by its own terms on December 31, 1965 (R. 45a), prior to the last two exercise periods under the option agreement.

notice of the election to exercise and tender of the purchase price in cash (or certified or cashier's check). (R. 46a.) Guild's oral demand for the stock failed to meet these requirements. Guild's argument (Br. 25) that it would have been futile to exercise the options in the required manner misses the point. ^{13/} An exercise, as contemplated by Regulations Section 1.421-1(e), must not only obligate the employer corporation to sell stock pursuant to the option, it must obligate the employee to purchase the stock. Guild's oral demand by itself did not obligate him to purchase any Logan stock.

Third, Guild has not established that New York law entitled him to exercise the option to purchase 15,000 shares of Logan stock upon his termination. We have no doubt that, had Guild established that he was wrongfully discharged and had thereby sustained damages, New York law would have granted him a remedy. The usual remedy, of course, is money damages. Guild argues (Br. 16-17), however, that since such a remedy would deprive him of potential capital gains treatment on any subsequent sale of the Logan stock, specific performance of the option contract would have been ordered. While we question the availability of equitable relief in these circumstances,

13/ Indeed, had Logan's president acceded to Guild's demand, Guild was not prepared to tender the consideration in the required form. (R. 137a.)

Guild has miscomprehended the law since, as noted above, Section 424(c)(1) would always prescribe ordinary income treatment with respect to a significant portion of the gain realized on Guild's subsequent disposition of the Logan stock. Moreover, the most Guild would have been entitled to would be the exercise of the options becoming available during the remainder of his employment agreement, i.e., the 5,000 shares which would have become available on April 1, 1965, and not the 6,500 shares which he ultimately purchased. However, an order enforcing the April 1, 1965, options would again fail to meet Section 424(a)(2)(B)'s three-month requirement. In addition, an order allowing Guild to purchase Logan stock at the time of his discharge would amount to a modification of the option agreement in at least two important respects, namely, that there be exercisable options at the time of discharge and abrogation of the gross sales and net profits conditions (R. 46a) contained in the option agreement. Under Section 425(h), such a modification would be treated as the granting of a new option which could not qualify as a restricted stock option because it would not have been issued before January 1, 1964 (Section 424(a)) and because Guild would not have been an employee of Logan's at the time of the modification (§1.421-2(a)(3), Treasury Regulations on Income Tax (1954 Code), Appendix, infra). In short, even if Guild had succeeded in gaining an order specifically enforcing the option agreement, no remedy fashioned by the New York courts could have secured to him the nonrecognition benefits of Section 421.

Finally, with respect to Guild's alternative argument, Logan's letter of November 20, 1967, was not a retroactive acceleration of the options to November 11, 1964, when Guild purportedly exercised the options. As discussed above, Guild's oral demand of Logan's president for his alleged rights under the option agreement did not constitute an "exercise" of the options. Nor were there any options available to be exercised on that date. Moreover, had Logan acceded to Guild's demands, the result would again be a modification of the option agreement which, as discussed above, could not qualify as a restricted stock option. ^{14/} In any event, as the Tax Court concluded (R. 50a), Logan's sale of stock to Guild was not an acceleration of the option agreement. Logan at all times denied that Guild had any remaining rights under the option agreement. The bargain sale of Logan stock to Guild was meant to compensate him for any damages he might have sustained due to the alleged breach of his entire employment contract. That this settlement did not relate solely to the option agreement is evident from the fact

14/ In light of the other modifications which we have mentioned, Guild's claim (Br. 26-29) that Logan's sale of stock to him in these circumstances would only amount to an acceleration of the option agreement is erroneous. Moreover, while Section 425(h)(3)(c) excludes from the definition of "modification" an acceleration, the legislative history indicates that such an acceleration must occur while the optionee is an employee of the issuing corporation. H. Conf. Rep. No. 1149, 88th Cong., 2d Sess., p. 39 (1964-1 Cum. Bull. (Part 2) 774, 812). Guild was not a Logan employee on November 11, 1964, when the alleged acceleration (retroactively) occurred.

that, pursuant to the settlement, Guild was permitted to purchase 6,500 shares of Logan stock whereas, under the option agreement, 5,000 shares was the greatest number he would have become entitled to during the remainder of his employment agreement.

We submit, therefore, that Guild's bargain purchase of Logan stock on November 20, 1967, did not constitute the exercise of a restricted stock option under Section 424, and Guild is not entitled to the nonrecognition benefits of Section 421.

C. Guild is not entitled to capital gains treatment with respect to his bargain purchase of Logan stock

As we discussed above, the bargain purchase of an employer's stock by an employee constitutes compensation taxable as ordinary income to the employee. Commissioner v. LoBue, supra. The same result obtains if the compensation is received as the fruits of litigation. Raytheon Production Corp. v. Commissioner, supra; Knuckles v. Commissioner, supra. Thus, Guild's bargain purchase of Logan stock in settlement of his lawsuit against Logan for breach of his employment contract constitutes ordinary taxable income to him.

Guild argues (Br. 30-36), however, that the settlement of his lawsuit against Logan constituted an exchange of his option rights for the Logan stock. Thus, he argues that he is entitled to capital gains treatment under Section 1234(a) of the Internal Revenue Code of 1954, Appendix, infra, citing (Br. 32) Turzillo v. Commissioner, 346 F. 2d 884 (C.A. 6, 1965). However, Section 1234(d)(2), Appendix, infra, excludes from the

application of that section any gain attributable to the sale or exchange of an option if such gain would be considered as ordinary income without regard to Section 1234.

Compensatory stock options are included within this exception.

§1.1234-1(e)(1), Treasury Regulations on Income Tax (1954 Code), Appendix, infra. Since Guild's options in this case were clearly compensatory (Commissioner v. LoBue, supra), Section 1234 does not convert Guild's ordinary income into capital gain. Rank v. United States, 345 F. 2d 337 (C.A. 5, 1965); Kunsman v. Commissioner, 49 T.C. 62 (1967).

Guild's efforts to distinguish Rank and Kunsman (Br. 32-36) are without merit. The one distinguishing point which he relies upon is that in those two cases the options involved were exchanged for cash, while here Guild exchanged his options for the Logan stock subject to the options. Guild does not explain, however, how this factor changes the essential character of his options as compensation. As noted, it is the nature of the option itself, not the consideration received in exchange therefor, which determines the nature of the gain. Guild's options being compensatory, his gain on exchanging them is ordinary income. Moreover, Guild's arguments (Br. 34-36) based upon the legislative history of the statutory stock options is irrelevant since, as shown above, his bargain purchase of Logan's stock does not qualify for the special benefits of those provisions.

Turzillo v. Commissioner, supra, is not in point. The taxpayer involved in that case was an employee of a corporation and also owned stock in such corporation. In addition, the corporation-employer had an option to purchase another shareholder's stock which, if exercised, would make that taxpayer a 50-percent owner of the corporation. The opportunity thus to become a 50-percent owner was eliminated, under the circumstances of that case, when the taxpayer's employment with the corporation was terminated. The taxpayer sued the corporation for wrongful discharge, and the Sixth Circuit held that the portion of the settlement proceeds attributable to the taxpayer's lost opportunity to become a 50-percent owner of the corporation was taxable as capital gain. As is evident, the option involved in that case was an asset of the corporation and was related to that taxpayer's ownership of the corporation's stock, a capital asset. The damages he sustained relative to this option were likewise related to his stock ownership, and were therefore property treated as capital gain. No such situation is involved in this case.

D. The Tax Court did not abuse its discretion in denying Guild's post-opinion attempts to raise the new issue of possible restrictions on the Logan stock

The parties stipulated prior to the trial of this case that the fair market value of Logan stock on November 20, 1967, the date Guild purchased 6,500 shares of such stock in settlement of his lawsuit, was \$54.50 per share. (R. 62a.) On the

basis of this stipulation, the Tax Court found that the 6,500 shares purchased by Guild had a total fair market value of \$354,250. (R. 48a.) Guild now argues (Br. 37-), in effect, that this finding is erroneous.

Guild's argument proceeds as follows: (1) under Regulations Section 1.61-2(d)(5), Appendix, infra, if property received as compensation is subject to a restriction which has a significant effect on value, the time such property is taken into income is determined under Regulations Section 1.421-6(d)(2); (2) under Regulations Section 1.421-6(d)(2), Appendix, infra, property subject to a restriction which has a significant effect on value is not taken into income until such restriction lapses or the property is disposed of; (3) stock which is subject to restrictions on sale imposed by the securities laws is subject to a restriction which has a significant effect on value, Hirsch v. Commissioner, 51 T.C. 121 (1968);^{16/} (4) the Logan stock he received was subject to an investment representation under the securities laws (so-called "letter stock") which constituted a restriction on his disposition of such stock having a significant effect upon its value; (5) consequently, he need not take the value of such stock into income in 1967.

^{16/} Guild does not actually cite the Hirsch case for this proposition. Instead, he quotes (Br. 39) the Int. Rev. Manual, Prime Issue Case Guidelines, No. 0421.01-01(2)(a)10, which cites Hirsch.

^{17/} For discussions of the private offering exemption to securities registration and the role of the investment letter, see Note, A Primer on Private Offerings, 24 U. Fla. L. Rev. 458 (1972), and Morrow, The Investment Letter Dilemma and Proposed Rule 144: A Retreat to Confusion, 11 Santa Clara Lawyer 37 (1970).

What Guild only mentions in passing (Br. 40), however, is that this argument was not raised in the Tax Court until after that court had filed its opinion in this case. The issue of possible restrictions on the Logan stock was not raised in Guild's pleading or at any other stage of the litigation below prior to his motion to the Tax Court to reconsider its opinion in this case. That motion was filed on February 19, 1975, and denied by the Tax Court on February 25, 1975. (R. 9a.) Guild raised the argument again, and a hearing on the issue was held on April 9, 1975. At this hearing, Judge Wiles specifically ruled (Tr. 14) that since Guild had not raised this issue in the pleadings, it would not be considered. Maxcy v. Commissioner, 59 T.C. 716 (1973); Shomaker v. Commissioner, 38 T.C. 192 (1962). This ruling of the Tax Court cannot be set aside unless Guild shows that the Tax Court abused its discretion. Weiller v. Commissioner, 64 F. 2d 480 (C.A. 2, 1933).

Guild makes no argument whatsoever that the Tax Court abused its discretion in denying his motion for reconsideration. The only oblique reference he makes (Br. 38) in this regard is that the Internal Revenue Service Manual, whence he discovered this argument, was not published until after the Tax Court filed its opinion in this case. However, Hirsch v. Commissioner, supra, upon which the Internal Revenue Service's position as expressed in the Manual is based, was decided in 1968. The Commissioner issued an acquiescence in Hirsch in 1970. 1970-2 Cum. Bull. xx. Guild has no basis in urging that he could not have been

aware of the Service's position on this issue prior to the filing of his petition to the Tax Court in 1972. (R. 8a.)

In addition, the record is silent as to whether the stock Guild received was in fact subject to any securities restrictions. In his brief Guild states (p. 40) that it was not until the Commissioner and Logan filed their post-trial briefs below that he became aware that the Logan treasury stock may have been subject to an investment restriction. The fair implication of that statement is that he did not believe that the stock was restricted when he purchased it in 1967. This fact, coupled with the fact that Guild was not an insider when he purchased the stock, renders the merit of his claim of restriction highly doubtful. Thus, for this reason also, the Tax Court's refusal to grant Guild's untimely attempts to raise this new issue was not an abuse of discretion.

Commissioner's Cross-Appeal in No. 75-4123:

IF GUILD DOES NOT RECOGNIZE INCOME ON HIS BARGAIN PURCHASE OF LOGAN STOCK, OR IF SUCH INCOME IS CAPITAL GAIN, HE IS NOT ENTITLED TO A DEDUCTION FOR ATTORNEY'S FEES IN CONNECTION WITH HIS LAWSUIT

If this Court should hold that Guild must recognize ordinary taxable income on his bargain purchase of Logan stock in settlement of his lawsuit against Logan, the Government concedes that he is entitled to a deduction for the attorney's fees he paid in connection with that lawsuit under Section 212 of the Internal Revenue Code of 1954 (26 U.S.C.).

If this Court should conclude, however, that Guild need not recognize income on this bargain purchase of stock, the

attorney's fees he paid in connection with his lawsuit against Logan are properly treated as expenses incurred in acquiring a capital asset (i.e., the Logan stock) which are not deductible but must be added to his basis in the stock. Woodward v. Commissioner, 397 U.S. 572 (1970); §1.263(a)-2, Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.). Similarly, if this Court should hold that Guild realized income on this transaction, but that such income is capital gain, the attorney's fees paid in connection with acquiring such income would be properly regarded as incurred in connection with his disposition of a capital asset (i.e., the stock option) and, again, would not be deductible against ordinary income but would be an offset against the gain realized. Victoria Paper Mills Co. v. Commissioner, 32 B.T.A. 666 (1936), aff'd per curiam, 83 F. 2d 1022 (C.A. 2, 1936). See also, Spreckles v. Helvering, 315 U.S. 626 (1942).

We wish to emphasize that the Government raises this issue only protectively, in the event that this Court should rule in favor of Guild on any of the issues he has raised. If this Court should affirm the Tax Court on those issues, the Government is satisfied with the lower court's decision.

Commissioner's Appeal in No. 75-4201

IF GUILD'S BARGAIN PURCHASE OF LOGAN STOCK CONSTITUTED THE EXERCISE OF A RESTRICTED STOCK OPTION UNDER SECTION 424, LOGAN IS DISALLOWED A DEDUCTION WITH RESPECT THERETO UNDER SECTION 421

As discussed above in connection with Guild's appeal, he is entitled to the nonrecognition benefit of Section 421(a)(1) only if his bargain purchase of Logan stock constituted the exercise of a restricted stock option under Section 424. If this Court should rule that the transaction so qualifies, Section 421(a)(2) disallows Logan any deduction under Section 162 (26 U.S.C.) with respect to such transaction. That is, the single determination under Section 424 triggers inverse consequences to Guild and Logan under Section 421(a): if the transaction qualifies under Section 424, Guild recognizes no income and Logan gets no deduction; if the transaction does not qualify under Section 424, Guild must recognize income and Logan is allowed a deduction.

The Tax Court determined that this transaction did not qualify under Section 424. (R. 52a.) Consequently, it held that Guild must recognize income and Logan is allowed a deduction under Section 421. (R. 52a.) The Government's position on this issue before this Court is primarily that of a stakeholder, and would first urge that this Court treat both parties consistently. That is, if this Court should reverse the Tax Court on this issue in Guild, Section 421 requires a similar reversal in Logan.

However, again we wish to emphasize that the Government appeals in Logan only protectively, in the event that this Court should rule in Guild's favor on the Section 424 issue. As set forth earlier in this brief, we believe the Tax Court correctly decided this issue and that its decisions should be affirmed.

CONCLUSION

The decisions of the Tax Court are correct and should be affirmed. If, however, this Court should reverse the decision in Guild on any of the issues he has raised, that decision should also be reversed with respect to the Tax Court's allowance of Guild's attorney's fees as a deduction. Finally, if this Court should reverse the decision in Guild on the Section 424 issue, the decision in Logan should likewise be reversed.

Respectfully submitted,

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DECEMBER, 1975.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel, by mailing four copies thereof to each on this 5th day of December, 1975, in envelopes, with postage prepaid, properly addressed to each of them, respectively, as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * *

SEC. 421 [as amended by Sec. 221(a), Revenue Act of 1964, P.L. 88-272, 78 Stat. 19]. GENERAL RULES.

(a) Effect of Qualifying Transfer.--If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a), 423(a), or 424(a) are met--

(1) except as provided in section 422(c)(1), no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, with respect to the share so transferred; and

(3) no amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

* * *

SEC. 424 [as added by Sec. 221(a), Revenue Act of 1964, supra]: RESTRICTED STOCK OPTIONS.

(a) In General.--Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise after 1949 of a restricted stock option, if--

(1) no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, and

(2) at the time he exercises such option--

(A) he is an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, or

(B) he ceased to be an employee of such corporations within the 3-month period preceding the time of exercise.

(b) Restricted Stock Option.--For purposes of this part, the term "restricted stock option" means an option granted after February 26, 1945, and before January 1, 1964 (or, if it meets the requirements of subsection (c)(3), an option granted after December 31, 1963), to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if--

(1) at the time such option is granted--

(A) the option price is at least 85 percent of the fair market value at such time of the stock subject to the option, or

(B) in the case of a variable price option, the option price (computed as if the option had been exercised when granted) is at least 85 percent of the fair market value of the stock at the time such option is granted;

(2) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him;

(3) such individual, at the time of option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. This paragraph shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value of the stock subject to the option, and such option either by its terms is not exercisable after the expiration of 5 years from the date such option is granted, or is exercised within one year after August 16, 1954. For purposes of this paragraph, the provisions of section 425(d) shall apply in determining the stock ownership of an individual; and

(4) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted, if such option has been granted on or after June 22, 1954.

(c) Special Rules.--

(1) Options under which option price is between 85 percent and 95 percent of value of stock.-- If no disposition of a share of stock acquired by an individual on his exercise after 1949 of a restricted stock option is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, but, at the time the restricted stock option was granted, the option price (computed under subsection (b)(1)) was less than 95 percent of the fair market value at such time of such share, then, in the event of any disposition of such share by him, or in the event of his death (whenever occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross

income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies--

(A) in the case of a share of stock acquired under an option qualifying under subsection (b)(1)(A), an amount equal to the amount (if any) by which the option price is exceeded by the lesser of--

(i) the fair market value of the share at the time of such disposition or death, or

(ii) the fair market value of the share at the time the option was granted; or

(B) in the case of stock acquired under an option qualifying under subsection (b)(1)(B), an amount equal to the lesser of--

(i) the excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(ii) the excess of the fair market value of the share at the time the option was granted over the option price (computed as if the option had been exercised at such time).

In the case of a disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount so includible in his gross income.

SEC. 425 [as added by Sec. 221(a), Revenue Act of 1964, supra]. DEFINITIONS AND SPECIAL RULES.

* * *

(h) Modification, Extension, or Renewal of Option.--

(1) In general.--For purposes of this part, if the terms of any option to purchase stock are modified, extended, or renewed, such modification, extension, or renewal shall be considered as the granting of a new option.

* * *

(3) Definition of modification.--The term "modification" means any change in the terms of the option which gives the employee additional benefits under the option, but such term shall not include a change in the terms of the option--

(A) attributable to the issuance or assumption of an option under subsection (a);

(B) to permit the option to qualify under sections 422(b)(6); 423(b)(9), and 424(b)(2); or

(C) in the case of an option not immediately exercisable in full, to accelerate the time at which the option may be exercised.

If a restricted stock option is exercisable after the expiration of 10 years from the date such option is granted, subparagraph (B) shall not apply unless the terms of the option are also changed to make it not exercisable after the expiration of such period.

* * *

SEC. 1234 [as amended by Sec. 53, Small Business Tax Revision Act of 1958, P.L. 85-866, 72 Stat. 1606].
OPTIONS TO BUY OR SELL.

(a) Treatment of Gain or Loss.--Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, a privilege or option to buy or sell property shall be considered gain or loss from the same or exchange of property which has the same character as the property to which the option or privilege relates has in the hands of the taxpayer (or would have in the hands of taxpayer if acquired by him).

* * *

(d) Non-application of Section.--* * *

* * *

(2) in the case of gain attributable to the sale or exchange of a privilege or option, any income derived in connection with such privilege or option which, without regard to this section, is treated as other than gain from the sale or exchange of a capital asset;

* * *

Treasury Regulations in Income Tax (1954 Code) (26 C.F.R.):

§1.61-2 Compensation for services, including fees, commissions, and similar items.

* * *

(d) Compensation paid other than in cash--
(1) In general. If services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income. If the services were rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary. However, for special rules relating to certain options received as compensation, see § 1.61-15 and section 421 and the regulations thereunder.

(2)(i) Property transferred to employee or independent contractor. Except as otherwise provided in section 421 and the regulations thereunder (relating to employee stock options) and § 1.61-15, if property is transferred by an employer to an employee, or if property is transferred to an independent contractor, as compensation

for services for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income.

* * *

(4) Stock and notes transferred to employee or independent contractor. Except as otherwise provided by section 421 and the regulations thereunder (relating to employee stock options) and § 1.61-15, if a corporation transfers its own stock to an employee or independent contractor as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee or independent contractor. Notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt its fair discounted value computed at the prevailing rate. As payments are received on such a note, there shall be included in income that portion of each payment which represents the proportionate part of the discount originally taken on the entire note.

(5) Property transferred subject to restrictions. Notwithstanding any other provision of this paragraph, with respect to any property, other than an option to purchase stock or property, which is transferred by an employer to an employee or independent contractor as compensation for services, and which is subject to a restriction which has a significant effect on its value, the rules of paragraph (d)(2) of § 1.421-6 shall be applied in determining the time and the amount of compensation to be included in the gross income of the employee or independent contractor. For special rules relating to options to purchase stock or other property which are issued as compensation for services, see § 1.61-15 and section 421 and the regulations thereunder. This subparagraph is applicable only to transfers after September 24, 1959.

§1.421-1 Effective dates and meaning and use of certain terms.

* * *

(e) Exercise. For the purpose of section 421, the term "exercise", when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. An agreement or understanding by the employee to make payments under a stock purchase plan does not constitute the exercise of an option as long as the payments made remain subject to withdrawal by the employee.

* * *

§1.421-2 Restricted stock option.

(a) In general.

* * *

(3) At the time the option is granted, the relationship between the individual to whom an option is granted and the corporation granting the option (or a corporation which is a parent or subsidiary thereof) must be the legal and bona fide relationship of employer and employee. * * *

* * *

§1.421-6 Options to which section 421 does not apply.

* * *

(d) Options without a readily ascertainable fair market value. * * *

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(2)(i) If the option is exercised by the person to whom it was granted but, at the time an unconditional right to receive the property subject to the option is acquired by such person, such property is subject to a restriction which has a significant effect on its value, the employee realizes compensation at the time such restriction lapses or at the time the property is sold or exchanged in an arm's length transaction, whichever occurs earlier, and the amount of such compensation is the lesser of--

(a) The difference between the amount paid for the property and the fair market value of the property (determined without regard to the restriction) at the time of its acquisition, or

(b) The difference between the amount paid for the property and either its fair market value at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable.

If the property is sold or exchanged in a transaction which is not at arm's length before the time the employee realizes compensation in accordance with this subdivision, any amount of gain which the employee realizes as a result of such sale or exchange is includable in gross income at the time of such sale or exchange, but the amount includable in gross income under this subdivision at the time of the expiration of the restriction or the sale or exchange at arm's length shall be reduced by the amount of gain includable in gross income as a result of the sale or exchange not at arm's length.

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§1.1234-1 Options to buy or sell.

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(e) Other exceptions. Section 1234 does not apply to gain resulting from the sale or exchange of an option--

(1) To the extent that the gain is in the nature of compensation (see sections 61 and 421, and the regulations thereunder, relating to employee stock options);

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